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REMARKS:	
<p>This was presented by Kissinger at a meeting at the White House last week.</p>	
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NSC review completed.

Talking Points

I. The Issues

We are entering an era of deep and dangerous change in our relations with the Soviet Union. Its leadership is in transition. Its ability to transfer power smoothly is no greater now than it has been for the past sixty years. Its economy is in difficulty, its relations with its neighbors troubled in every quarter from Poland around to China, and it seems unable for domestic reasons and unwilling for ideological ones to relax its headlong pursuit of military power.

For our part, the changing nature of East-West relations has introduced new strains into the Alliance. Western financial banks are exposed in the East. Official Western trade practices are undisciplined and unsettled. Western views on nuclear policy and the meaning of Third world ferment in El Salvador and elsewhere for the superpowers are sharply divided.

The manifest consequences of these new conditions of East-West relations have been two:

-- an increase in Soviet adventurism, and

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-- an erratic response by the industrial democracies to that adventurism.

A. Even in "crisis-free" conditions, the economic relationship between East and West has been permitted to tilt toward the Soviets.

-- From the theoretical economic standpoint, trade takes place only when it is to the mutual advantage of both parties: trade is a plus not a zero sum game. But the gains from trade are not always evenly distributed. The division of the gain between two parties is the subject of the bargaining process (including the use of non-economic trade-offs).

-- Both buyers and sellers can be severely squeezed by over-dependence on one buyer or seller. This factor has always led prudent buyers and sellers to diversify sources and markets.

-- The USSR sums buyers or sellers together when it approaches a Western market, typically buying through a purchasing commission. The Western side, by contrast, is characterized by many participants and collaboration among U.S. sellers is often banned by our anti-trust laws. The result is that the USSR

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is a coordinated market participant, while the Western side lacks coordination.

- Another special and increasingly unfavorable feature of recent East-West trade involves the non-material (technological) aspects of our export transactions. The principal items from the East of interest in the West are raw materials: oil, timber, minerals. They contain no ideas as articles for sale. Western manufactured goods sold to the East, by contrast, are typically loaded with scientific and engineering ideas.
- Thus, broadly speaking, the balance of relative advantage seems somehow to have been turned upside down. One would think that the primitive Soviet economy would have more to gain from East-West trade. A kind of dependency on advanced products, let alone grains, should have developed by now. But reality appears to be otherwise. Producer pressures and concern about rippling effects of a financial squeeze have put more apparent pressure on the West than on the East.
- In the financial arena, furthermore, the record shows that Western governments bear a major share

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of the responsibility for the uncontrolled expansion of East block, and particularly Polish, debt in the period after 1975. Loans were offered in the name of Ostpolitik or export promotion with little or no consideration of ability to use or repay the funds. There has been no clearly defined policy toward Eastern Europe. In 1976, the Ford Administration initiated an effort within the OECD to examine the implications of East-West trade and credits and to develop a framework for managing these relations. The Carter Administration abandoned the effort. The result was a leadership vacuum. Europe saw little reason not to pursue narrow economic interests without reference to the broader security concerns of the Western Alliance. The consequence was a massive rise in Western credit to the East.

B. Even more significantly, perhaps the West has been singularly unable to turn its trade and financial power to advantage during times of East-West crisis. Poland and Afganistan taught stern lessons. They made it embarassingly clear that we have no effective Alliance sanctions policy against Soviet adventurism.

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- We have learned that stop-start sanctions do not work. To respond with new pinpricks to every irritant in the relationship is too episodic. Trade and financial relations are built over the long term. They cannot be turned off and on overnight.
- Conventional sanctions are increasingly ineffective. We are close to the bottom of the list of trade measures which hurt the Soviets more than they hurt us. Witness the difficulty over grain and the gas pipeline.
- In the past, sanctions have been announced but there has been no follow-through. "Ringing proclamations of truth, but no consequences," as some have put it. Our reputation for firmness and reliability suffers.

The West possesses the overwhelming share of the world's economic power. Given the stakes -- and the opportunities -- it is unthinkable that we should continue to deal with the Soviet Union in the disorganized way we have in the recent past. The West must not permit the Soviets to assault the geopolitical balance without penalty or to solve its economic problems by means of Western aid without paying the political price -- if that is the right word -- of restraint and stability in international conduct.

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- To act otherwise is to license Soviet adventurism.
- It also risks exposing the Western trade and financial system to greater Soviet pressure. Our banks become hostage to economic policy decisions made in Moscow.
- But most important, it would forego the most effective means available for arranging a comprehensive understanding between the two superpower systems, including both political and economic components.

Poland made clear that the Communist economic system is rotting. Poland alone will be asking for billions of fresh Western credits this year just to keep its economy afloat. There is no prospect that the private market will finance this on its own. Indeed, while U.S. government credits to Poland rose from \$321 million at end of 1976 to \$1.8 billion in 1981, loans from U.S. banks are no greater today than they were then. The government-guaranteed portion of Poland's gross foreign debt increased from 20% to 50% during the same period. In short, government policy is central. The economic rot in the East represents an historic opportunity for the West.

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The issue which deserves priority attention is not what to do about the past -- not whether Poland should formally be declared in default, for a particular example. (Indeed, the Group is opposed to a formal politically-motivated declaration of default at this time for a variety of reasons, not the least of which is the fact that the present arrangement imposes the maximum strain on the East Bloc financial system and does not transfer the onus of non-payment to the U.S.) The issue is an issue of the long-term future: whether and on what terms the nations of the Soviet system will enjoy access to Western trade and financial resources in the years to come.

II. The Options

The Group conceives it to be a matter of the highest priority that the United States and its allies design a coherent strategy to govern the future economic relationship between the East and the West in the years ahead. We see the issue as yielding three broad options to official policymakers:

- the first option is the option of economic warfare
 - a policy of attempting to force the Soviet system to its knees, based upon the premise that the stern and unrelenting pressure of trade and financial denial will over time lead to fundamental change within the Soviet system.

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- the second option would be a period of disciplined economic pressure designed to open the door to comprehensive negotiations between the East and the West. These negotiations would look, on the one hand, to the articulation of canons of restraint in matters of concern to the respective sides, and, on the other, would explore principles of enhanced cooperation and mutual economic accommodation.
- the third option would be to continue the practices of the past, permitting trade and financial relations to turn largely on market considerations, and with precious little coordination of the occasional but significant interventions by Western governments in that market, all in the hope that expanding trade and a thickening network of economic ties will somehow in the natural course of things lead to an amelioration of the Soviet system.

The Group leans to the second course. It is the view of the majority that considerations of overall political strategy must govern the economic relations between East and West in the future. The market test must be a necessary, but it is not a sufficient, condition to regulate future trade and financial transactions. Bankers and traders can be relied on

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to apply that market test. But Western governments must design a political framework for the economic links: -- to preserve their own alliance, to diminish the prospects that their financial and trading institutions will be vulnerable to manipulation by the Soviets and over the long term to take advantage of the most significant lever available on Soviet behavior.

We believe that a period of coordinated restraint by the West may achieve these objectives. It could lead over a period of years to a wide expansion of economic contacts and trade and credit in return for real restraint in Soviet conduct -- a comprehensive economic deal for a comprehensive political deal, in other words. But such an effort will require careful analysis of at least four related issues:

1. First, we must decide exactly what it is we want. We must strike a balance beforehand between our political and economic objectives in the nuclear arena, conventional armament reductions and restraint in Soviet and proxy behavior in the Third World.

2. Second, we must determine what the West is prepared to do by way of disciplined restraints. This includes both the question of what trade restraints the United States will impose on its exports and imports from the Soviet bloc, what

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trade measures we can and may expect to arrange with Europe and Japan, and how all the Western governments can cope with their domestic pressures for concessions. To take an important illustration, it may well be that with respect to the gas pipeline it would be more effective not to attempt any further cut off of the first line but to bring pressure to bear with respect to the second, and to that end rely primarily on the development of alternative sources of supply, such as Norwegian gas.

3. The third issue is to develop in the West a new understanding of the real purpose of sanctions. The problem has been particularly difficult in the past for the Europeans because they have conceived that we were reaching for the first option -- economic warfare -- rather than the second -- disciplined economic pressure designed to lead to positive understanding. But the United States cannot act effectively by itself. Even as to grain, an embargo would hurt us more than the Soviets unless Argentina, Canada, Australia and the Europeans cooperate. The Group believes that the chances that our Allies will go along in the future will be markedly increased if there is a clear understanding that the ultimate purpose of our policy is not simply economic confrontation.

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4. The fourth problem is to define what we are prepared to offer the Soviets economically in the event that a period of economic discipline among the Allies helps open the way to a comprehensive arrangement.

The Group is persuaded that in designing such a strategy we hold a far stronger hand than the Communists. The problems of the West are serious problems of policy. The problems of the Soviet system are structural and basic. To the West belong the vast bulk of the world's resources and its heritage of human values. It cannot be beyond the wit of leadership to put together a strategy which takes full advantage of the historic opportunity before us.

III. The Next Step

The effort should be initiated at the Versailles summit conference. The proposal should include but go beyond the Buckley Mission's call for harmonization of official credit policies and exchange of financial information.

-- We should prepare a comprehensive declaration which would establish the principles of common policy within the Alliance (excluding nuclear issues) for dealing with the Soviet Union. We would make clear that the West sees its relations with the East in terms far broader than military -- economic, cultural, social and ideological.

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-- Within this framework, the Versailles initiative would emphasize that the strength of the West turns on its ability to speak to the East with one voice. It would suggest that the West consider a number of specific and concrete measures to improve coordination and discipline. These might include:

(1) An authentic commitment to modernize the common list of prohibited exports and to stick to it.

(2) A mechanism for exchanging information among all OECD governments about new credits to the East, public and private.

(3) An agreement to review regularly and actively the respective policies on export credits and financial guaranties, with a commitment to establish a common and non-competitive policy in this area among all the OECD members.

(4) Concomitantly, an agreement to harmonize or eliminate all government subsidies in such credits.

(5) An informal clearing house for information and communication among all Western banks active in Eastern Europe, with which the Allied governmental mechanisms referred to above may coordinate policy.

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(6) Above all a definition of the ultimate goal of what economic incentives we can offer as governments and what we desire in return. We must, in short, define both the tools at hand and our ultimate objectives.

The deterioration of the Soviet system is a danger and an opportunity for the West. An effective Western response along the lines proposed here should be seen in the same ambiguous way by the Soviet Union -- as a threat that the West will respond in a more disciplined fashion to future Soviet assaults on the international system, and as a promise that there are real benefits at hand in the form of Western economic cooperation if the Soviet Union is prepared to conduct itself with the restraint that our dangerous age demands.